They Know Not What They Do

By Editor Test *Tue, Aug 9, 2011*

The equity sell-off and rush to Treasuries didn't happen because Congress failed to cut the deficit or the debt aggressively enough. In my humble opinion, it happened for the opposite reason.

When Greek bonds were downgraded last year, their prices crumbled like ancient marbles in the Athens smog, only faster. But when U.S. bonds were downgraded last week, their prices rose. Meanwhile, the whole world dumped equities.

Maybe the bond market, unlike Congress or the odds makers at Standard & Poor's, doesn't equate the U.S. and Greece. Maybe it knows that the United States, unlike Greece, can and will always pay its debts in its own currency, with interest.

But here's my question: Was "the market" angry because last week's debt-ceiling deal didn't include a more aggressive debt-reduction plan? Or because it didn't include an economic stimulus?

It's the latter, in my opinion. If Obama and Bernanke had announced that they will spend whatever they can to jump-start the economy, I think the market would have rallied. (Indeed, the Fed announced at 2 p.m. yesterday that it would keep rates "exceptionally low" through 2013. The Dow rose more than 400 points.)

I speak as a recent convert to Modern Monetary Theory. MMT holds that unemployment is more destructive than inflation and that the government should spend whatever it has to in the short run and clean up any subsequent inflation—which is currently nowhere in sight—as the private economy improves. In other words, MMT holds that people are more valuable than money. Especially when that money can come from a central bank with a printing press.

You may not agree. Congress clearly doesn't agree. According to an article by Robert Pear in the *New York Times* a few days ago, Congress believes that the market is telling it to cut spending and balance the budget. That's like an anorexic person looking in a mirror and concluding, 'I'm so fat.' Or like the voice in Freddie Kreuger's head that says, 'Kill, kill!'

The deficit hawks, the hard-money men, apparently believe that people are dumping stocks because they're afraid that the threat of a Greek-like debt meltdown will destroy the U.S. economy. But a Greek tragedy isn't what's playing out here. The U.S. isn't like Greece. If it were, the smart money would *sell* Treasuries, not *buy* them.

People much wiser than me were blogging away on this issue yesterday and this morning. At Moslereconomics.com, a pro-MMT site, Warren Mosler wrote:

> "Looks to me like the recent sell off in stocks was mainly technical, as the initial knee jerk sell off from the debt ceiling and downgrade uncertainties triggered further selling by those with short options positions, much like the crash of 1987…

> "Like then, and unlike early 2008, the current federal deficit seems more than large to me to keep things chugging along at muddle through levels of modest growth, continued too high unemployment, and decent corporate profits and investment.
>
> "Yes, risks remain. Europe is a continuous risk, but the ECB, once again, stepped in and wrote the check. China looks to be slipping but the lower commodity prices will help US consumers maybe about as much as they hurt the earnings of some corps. So for now, with the options related stock selling over, it looks like we're back to calmer waters for a while."

At Zerohedge, a site that some people respect, Tyler Durden suggested that investors dumped equities because they've recognized that the equities market, shorn of quantitative easing and rock-bottom rates, is an emperor without clothes:

> "For Treasuries to rally in a flight to quality as a market reaction to their own downgrade is a flight to the relative safety that remains. Anticipation of the deflationary political discipline of an S&P downgrade is the rational reaction of capital flight away from securities propped up by the reflationary status quo…
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> "Policy choices are clearly between a deflationary deleveraging/purging of mal-investment or a reflationary protection of the status quo international money center banking system to the detriment of wage earner and pensioner standards of living."

Durden believes that the expectation of deficit-cutting—i.e., "deflationary political discipline"—triggered the equities sell-off. He seems to oppose any further monetary stimulus—like the low rates the Fed promised today—that merely keep stock and bond prices inflated above their true value and prevent the recognition of bad debt. Is there a safe way to let asset prices correct while raising employment?

An articulate champion of MMT, the Australian economist Bill Mitchell, who believes that everyone who needs work should be able to find work, recommended this yesterday:

> "The first thing the US government should do today when they wake up is enact legislation to outlaw the ratings agencies. The second thing they should do is increase their deficits and introduce a Job Guarantee. The third thing they should do is enjoy the political credit that will flow from reducing unemployment."

Finally, at the end of the day, I turned to AdvisorPerspectives, a newsletter that publishes market commentary. John Hussman, a mutual fund manager I met last spring at a Morningstar conference, wrote this:

> "Another round of policies geared to creating an even larger sea of zero-interest liquidity, re-igniting asset bubbles, or further lowering already depressed Treasury yields, would be a signal of panic and incompetence from the Fed.
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> "If policy makers instead push to facilitate debt restructuring, coupled with pro-growth fiscal

> responses (e.g. R&D investment incentives, full funding of the National Institutes of Health, productive infrastructure investment, etc.), yet another drawn-out cycle of distortion and crash might be avoided."

Now, that's a policy I could support. Unfortunately, the House of Representatives has removed all hope of fiscal stimulus as long as the Tea Party holds power. That loss of hope, in my humble opinion, and not the faraway threat of big deficits or a meaningless S&P downgrade, is what shocked the markets.